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Sanctioned default? The English High Court considers the effect of foreign illegality on English obligations

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As sanctions ramp up globally, it is increasingly important for commercial parties engaged in cross border transactions to have certainty (i) as promises (*e.g.* lenders) as to when their counterparties may legitimately avoid their contractual obligations; and (ii) as promisors (*e.g.* borrowers) as to how to protect themselves against the risk that performance of their contractual obligations may violate sanctions (potentially exposing them to ruinous penalties).

Under English law, it is well-established that a party will not be excused from contractual performance by reference to a foreign law unless that law is the law governing the contract or of the place of performance. That said, parties can manage the risks associated with foreign laws having extra-territorial effect through express contractual provisions.

The English High Court's recent decision in *Lamesa Investments Limited* ("**LIL**") *v Cynergy Bank Limited* ("**CBL**") provides welcome guidance on these issues.[1] The judgment considers the importance of careful drafting if parties wish, contrary to the default position under English law, to excuse contractual performance by reference to a foreign law, which is not the law of the contract or place of performance. In Lamesa the Court found in favour of the UK-incorporated debtor defendant, holding that it did not default under its English law facility agreement by failing to pay where compliance with the payment obligation would risk a penalty under new US sanctions.

Background

The Facility Agreement

In December 2017, LIL, a Cypriot company, part of a group wholly owned by Mr Viktor Vekselberg ("**VV**"), entered into an English law governed £30m facility agreement as lender with CBL, an English retail bank, as borrower (the "**FA**"). Clause 9.1 of the FA provided that CBL's non-payment would be a default unless:

"…*such sums were not paid in order to comply with any mandatory provision of law, regulation or order of any court of competent jurisdiction.*"

1 [2019] EWHC 1877 (Comm).

The FA defined "*regulation*" as including those of any governments; however, it did not define the expression "*mandatory provision of law*".

Nothing in the FA required payment to be made in US$ or into a US bank account. CBL's only connection with the US was that it carried on a US$ denominated business, for which it was necessary to maintain a US$ correspondent account with a US bank, where it held US$15m.[2]

Sanctions on VV

In April 2018, the US imposed sanctions on VV and LIL became a "*blocked person*". As such, any US person was expressly prohibited from dealing with LIL, classified as a "*primary sanction*". Relevant to CBL, the US government could impose a penalty on any non-US person if that person knowingly facilitated a "*significant financial transaction*" on behalf of LIL, classified as a "*secondary sanction*".[3] The applicable penalty under this secondary sanction was a ban or strict conditions on the non-US person holding a correspondent account'; potentially "*ruinous*" for CBL, a consequence accepted by both LIL and the Court.

Dispute

LIL brought a claim in the English High Court seeking a declaration that CBL had to repay interest which had become due[4] (£3.6m), irrespective of the intervening sanctions. CBL defended the claim, submitting that since payment of the interest was "*at least arguably*"[5] a "*significant financial transaction*"[6], CBL was at a "*realistic risk*" of becoming subject to the sanctions and, in those circumstances, it could rely upon clause 9.1 of the FA to excuse performance of its obligation to pay interest.

LIL in contrast contended:

(i) that the secondary sanction was not "*mandatory*", as (it alleged) was required by the words used in clause 9.1, as "*mandatory*" required an express prohibition on CBL from making the payments (*i.e.* as under a primary sanction). Here, LIL argued, CBL was instead simply trying to avoid a "*possibility*" that the payment triggered a penalty; and

(ii) that the wording "provision of law" in clause 9.1 referred to a law that applied to a "…UK party, acting in the UK that has agreed to make a sterling payment pursuant to a contract governed by English law" (*i.e.* English law) and, therefore, illegality under US law was irrelevant to whether or not CBL had to pay the interest.

Decision

Before weighing the competing arguments, HHJ Pelling QC gave a helpful reminder of the position under English law where one party's performance becomes illegal after the date of an agreement (*e.g.* through the imposition of sanctions), namely:

(i) a party's non-performance will only be legitimate where the illegality arises under the law of (a) the contract or (b) the place of the performance,[7] (the default position); but

(ii) parties may contract out of this general position, so that illegality under the laws of other jurisdictions may, depending on the language used, excuse performance.

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2 CBL was also party to various US$ swap contracts and long term service contracts with US companies, into which it had previously entered.

3 Under Section 5(b) of the Ukraine Freedom Support Act 2014 (as amended). The power to impose penalties is subject to the President's express power to waive the imposition of that sanction.

4 CBL had paid the principal due before April 2018.

5 Public guidance made clear that the default position would be that sanctions would generally apply, however, there was no specific guidance on what would constitute a "*significant financial transaction*".

6 There was no realistic prospect of a presidential waiver.

7 For instance, in the absence of express or implied provision to the contrary, the place of performance for a debt is where the creditor carries on his business.

The question before the Court in *Lamesa*, therefore, was whether the wording used by the parties in clause 9.1 of the FA had the effect of modifying the default position under English law. If it did not, then LIL would be entitled to receive payment of the interest due under the FA, notwithstanding the commercial consequences for CBL.

Having considered the authorities on contractual interpretation, HHJ Pelling QC decided that CBL was, in the circumstances, entitled to avoid making the interest payments. His decision rested on a number of key issues:

(i) "Provision of law"

On the basis that CBL would be entitled to avoid payment where it needed to comply with a "*regulation*" of a foreign government or an "*order of a foreign court*", it would be inconsistent for the parties to have intended, by inclusion of the (unqualified) term "*mandatory provision of law*", to restrict CBL from avoiding payment in order to comply with foreign law. There was no justification for implying any territorial qualification such that the only relevant law was English law.

HHJ QC dismissed as "*immaterial*" the "*UK's longstanding policy of not giving extraterritorial effect to US foreign policy as enacted through its secondary sanctions programmes*", where the parties had included express terms in order to seek to manage the risk of secondary sanctions. To that end, HHJ Pelling QC sympathised[8] with an international bank's interest in protecting itself from very substantial liabilities as a result of disputes between its lender and third parties (here, the US government).

(ii) "Mandatory"

The Court accepted CBL's submission that the meaning of "*mandatory*" should be "*a provision of law that the parties cannot vary or dis-apply"[9]. HHJ Pelling QC noted that "It makes sense for the parties to agree to such a provision where non-payment results from the need to comply with a provision of law that neither can dis-apply…*"[10] but perceived that in this dispute, there was a real issue over the meaning of the words "*in order to comply*".[11]

HHJ Pelling QC disagreed with LIL that "*in order to comply*" referred only to a law that expressly requires or prohibits something (*i.e.* a primary sanction), rather than one which creates a risk of penalty if something is not done (*i.e.* a secondary sanction). He observed that it was long recognised in English law that a statute imposing a penalty will be treated as an implied prohibition; a party who acts to avoid a penalty is "*complying with the implied prohibition just as much as a party who acts so as to comply with an express prohibition*".[12] In acting to avoid the risk of the penalty, CBL was doing so in order to comply with a provision of law that it could not vary or disapply.

Further contextual reasons weighed in favour of HHJ Pelling QC's decision:

First, as a non-US bank, the only risk to which CBL could have been exposed was of secondary sanctions, therefore it was improbable that the parties would have intended that clause 9.1 would capture only primary sanctions.

Second, clause 9.1 could serve no purpose unless it captured the "risk" of sanctions. Its purpose was to avoid "double jeopardy", *i.e.* CBL paying twice. However, this purpose could only be served prospectively, when only a "risk" would be discernible. Had clause 9.1 been limited to apply only to a crystallised or certain sanction, this would have undermined its benefit; CBL's only way to avoid paying twice would be by attempting, retroactively, to persuade the US government not to impose the sanction.

HHJ Pelling QC rejected LIL's complaint that to allow clause 9.1 to apply to a "risk" of a penalty would be too uncertain, stating that "*uncertainty is not an answer because the parties could not know for certain what was going to happen in the future*" – they could only be certain of the risk they had chosen to manage by the

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8 Applying Hamblen LJ's observation in *National Bank of Kazakhstan and another v. Bank of New York Mellon* [2018] EWCA Civ 1390 at paragraph 69.

9 At paragraph 22.

10 At paragraph 22.

11 At paragraph 24.

12 At paragraph 26.

wording used in clause 9.1. He also noted the requirement for such clauses to be widely drafted so as to avoid the "*rigours*" of the default English law position.[13]

Comment

The decision, to a large extent, turns on the particular language used by the parties in the FA. However, in light of its consideration of wider contextual factors, the decision raises some important points for international commercial parties as governments increasingly deploy sanctions to implement their foreign policy.

Without express language to derogate from the common law position, parties could still be on the hook to perform obligations that risk infringing foreign law, with the attendant risk of significant financial penalties. It is therefore crucial that parties contracting under English law with potential sanctions' exposure consider the use of express wording in their contracts to manage this risk effectively. Parties can account for the risk of intervening sanctions by the use of wide terms in their contracts. In this case, the verb "*to comply*" was interpreted as sufficient to capture acting in order to avoid the risk of penalty (not just in accordance with an express prohibition).

Finally, it is stark that CBL could avoid its payment obligations on the basis of the laws of a country totally unconnected to the performance and interpretation of the contract. HHJ Pelling QC's comments indicate that the English courts will be supportive of parties' attempts to manage their sanctions risk, in spite of the traditional tendency of the Courts to uphold English law contractual obligations where foreign law conflicts with them.

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[13] At paragraph 29.